



Beyond Reset

Why changing market dynamics
create a 'new normal' in the UK
dairy sector





Introduction

In our report '*Opportunities ahead – why the UK dairy industry can prosper from increased export demand*' published with support from NMR in October 2021, we outlined that there are enormous growth opportunities for UK dairy. The report showed that there was growing global demand for dairy, whilst some of the traditional dairy exporting nations are limited in their ability to grow because of environmental restrictions. Given the UK's strong track record in animal welfare and traceability, and its activity to reduce carbon emissions across dairy production and processing, this leaves the UK dairy producer potentially well-placed, if the processing sector innovates, to enable UK farmers to access these growth markets.

But will that happen? We know that there is enough milk supply in the UK. In addition, the climatic circumstances and technical competence to continue growing that supply exist. The demand outside the UK is growing. Moreover, the UK is a competitive and efficient place to produce milk. The key challenge will be whether UK processors wish to invest in processing facilities targeted at these growth export markets such as milk powders and cheese, or whether they'll continue their current focus.

Traditionally, the UK market has been dominated by liquid milk, which has constituted around a third of total UK dairy sales in value. This was always considered the premium market, which is why much of the investment in dairy processing in the last 20 years has focused on this area, rather than on export of cheese and powders. Beyond the liquid sector, the UK's dairy processors have been focused on serving the UK domestic market almost exclusively, with some 94% of their sales being realised within the UK rather than abroad.

Yet, in more recent years this has led to reduced returns from the liquid market because of intense price competition in the retail sector following the rise of the discounters. As this report will demonstrate, in its current state, the liquid market doesn't provide profitable returns for UK dairy processors nor the farmers that supply them, who are seeing lower returns than their competitors in other sectors.

The status quo may remain, but liquid milk processors now have a choice that was not available to them previously. With new dynamics in the marketplace, those processors serving the liquid market could now profitably invest in manufacturing facilities that allow them to access growth export markets with improved returns.





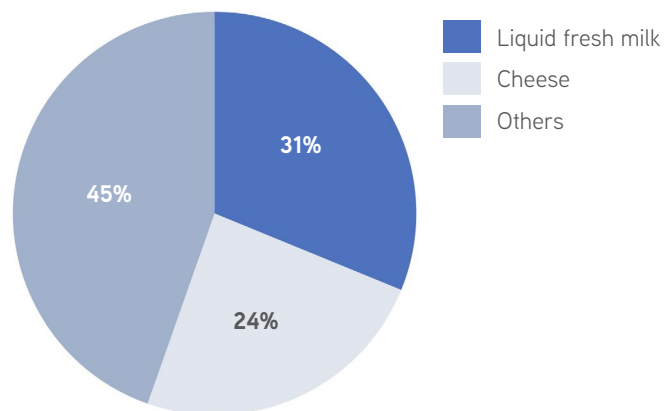
Analysis

The UK dairy processing sector is focused primarily on the domestic market, with 94% of sales staying within the UK and fresh milk accounting for around one third of sales on a value basis (although liquid sales are more than 50% on a volume basis).

Market served by GB-based processors (data for 2018; partly estimated)

Product mix

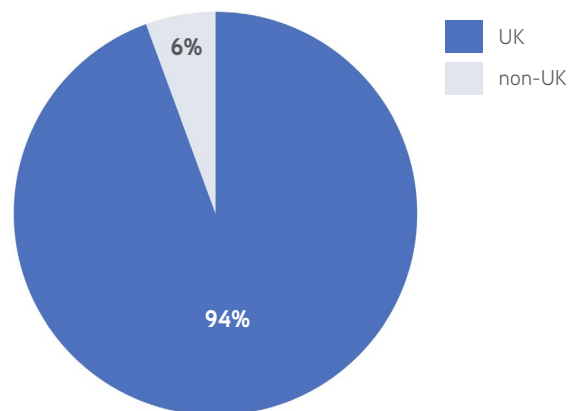
Others include: butter, milk powders, ingredients, UHT-milk, yoghurts
in % of net sales realised



Market served by GB-based processors (data for 2018; partly estimated)*

Geo-mix

GB dairy processors realise 94% of their sales in the UK
in % of net sales realised



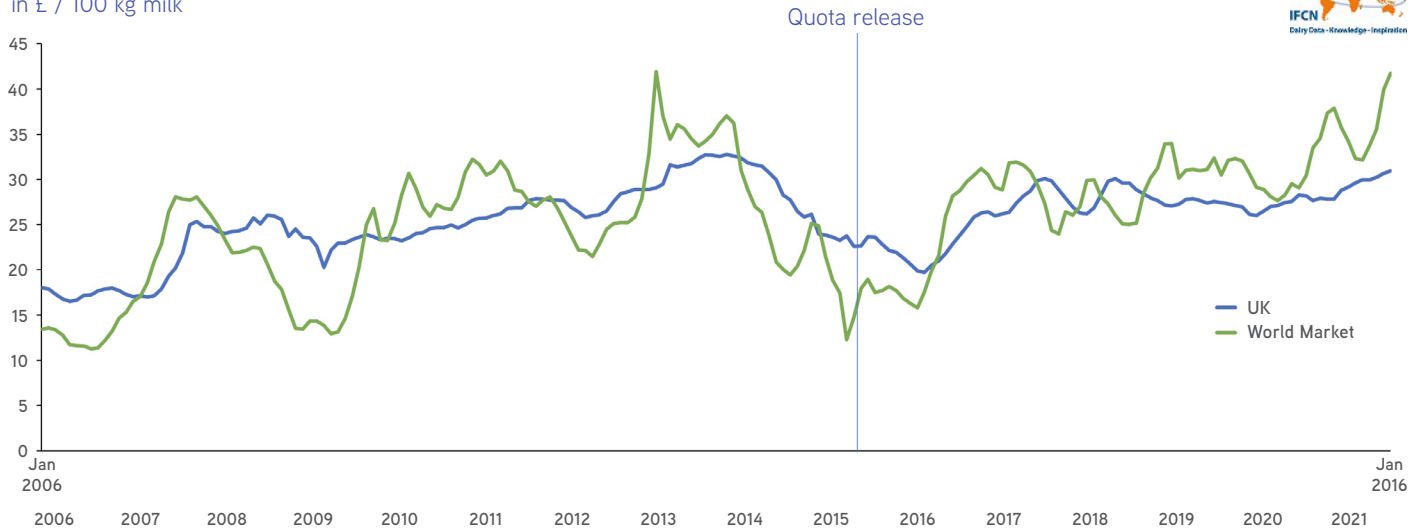
*data are available for **19 out of the 21** UK-based dairy processors. The weighted average by sales for these 19 companies shows that 94.4% of sales is realised in the UK in 2018.



Traditionally, world prices have been lower and more volatile than UK prices, with higher peaks and deeper troughs. Since the EU quota release in April 2015, the world market has structurally caught up and since 2019 UK raw milk prices have been behind world raw milk prices, particularly in the liquid market.

World Raw Milk price (IFCN, SMP/butter-based) and UK Milk Price (IFCN)

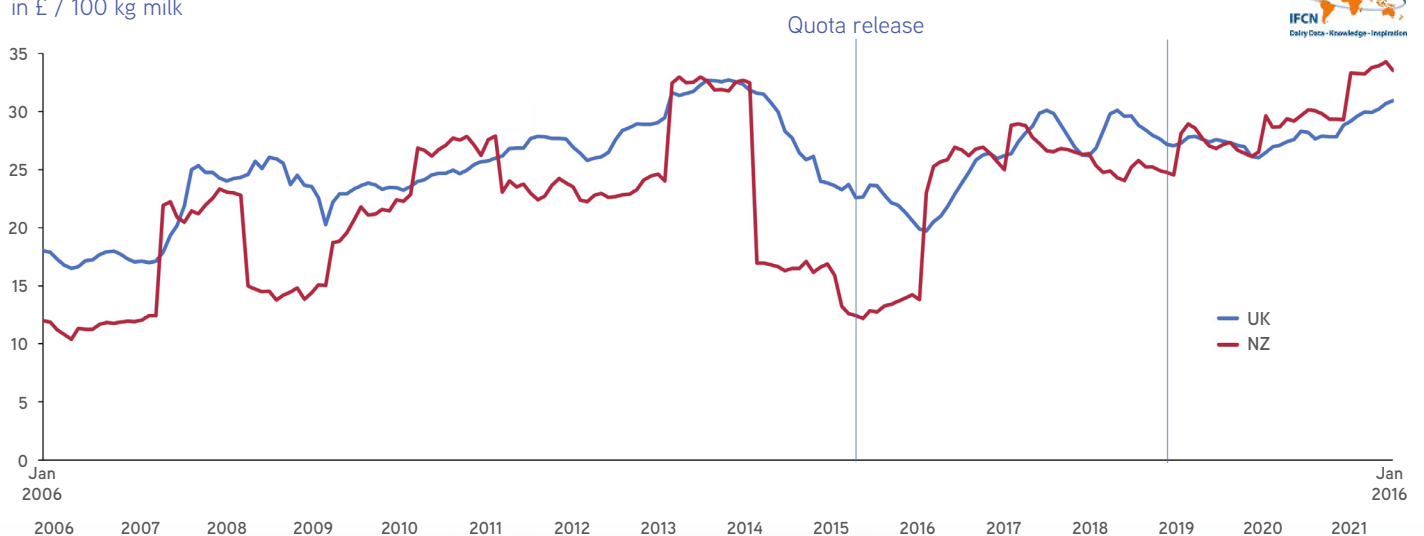
in £ / 100 kg milk



This is also the case for New Zealand milk prices, which almost never exceeded the UK price prior to 2015 and since 2019 have been higher.

NZ Raw Milk price (IFCN, ECM) and UK Milk Price (IFCN)

in £ / 100 kg milk



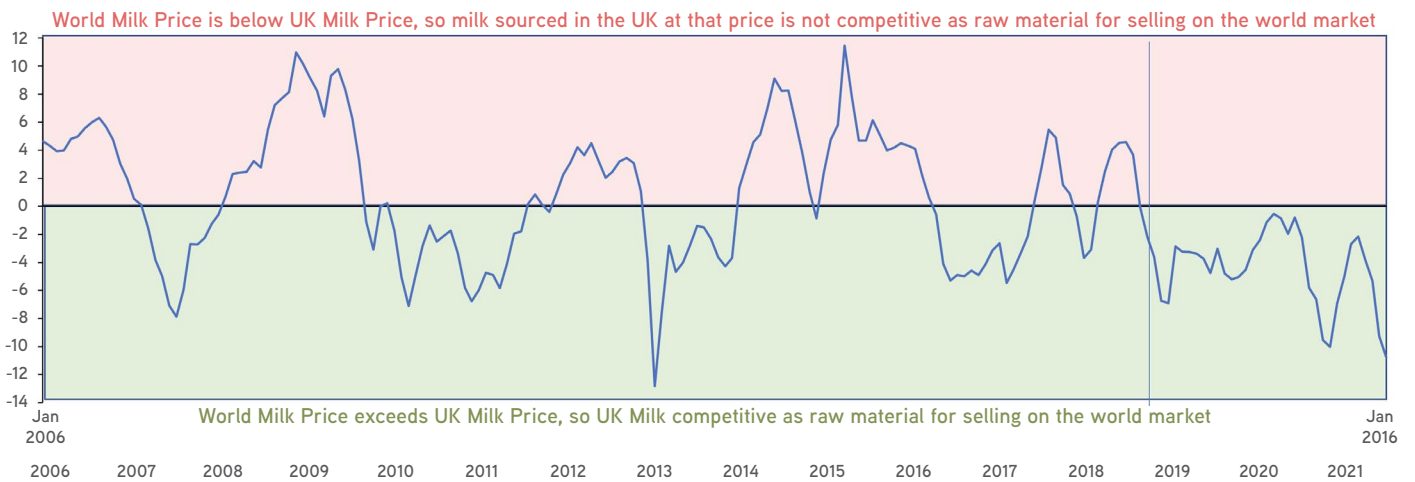
Some of this ties in with the depletion of the end of quota-release stocks of SMP in 2019 and it now appears to be a structural difference in price, rather than a short-term anomaly.

What this means is that UK milk is now competitive as a raw material for selling on the world market in a way that it hasn't consistently been previously.

UK Raw Milk price (IFCN) minus World Milk Price (IFCN, SMP/butter-based)

in £ / 100 kg milk

Data source:

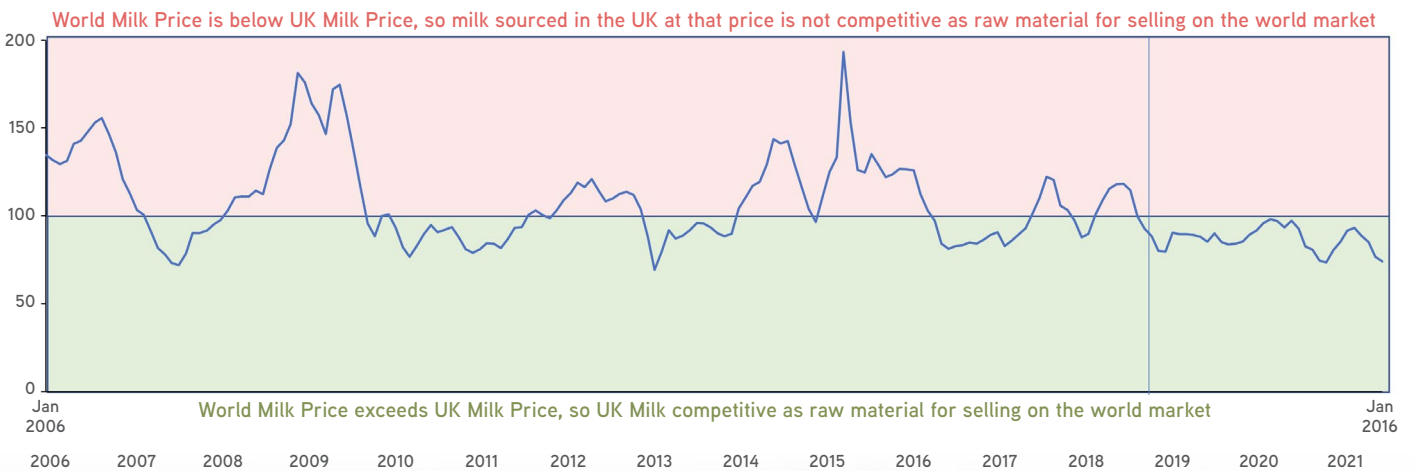


Indeed, since January 2019, the UK price has, on average, had an index of 84.7% of the average world milk price – an average difference of £4.29/100kg milk over that period.

UK Raw Milk price (IFCN) as percentage of World Milk Price (IFCN, SMP/butter-based)

in %

Data source:

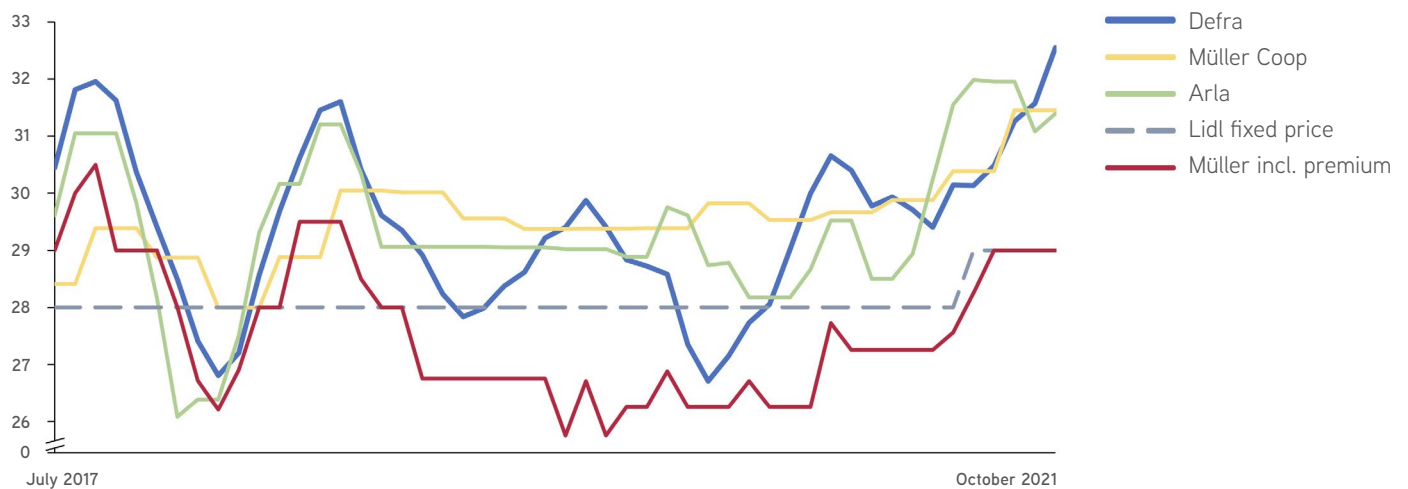


To illustrate the difference between average UK milk prices and the average pay-out from the UK liquid sector, an analysis of the Defra price index vs liquid contract payments has also been conducted. This shows that the main 'premium' liquid contracts have been consistently below Defra average pay-outs in recent months, demonstrating the poor returns from this market sector.

Milk price pay-out for different contracts (UK)

Period July 2017 – October 2021

in £ / 100 kg milk



So, what does this mean? It shows that we have a 'new normal' in relation to UK dairy prices versus world dairy prices, where the world market is at least as attractive as domestic markets. We also know that the liquid milk sector is under-performing in relation to the UK market overall.

This situation has the potential to drive structural change across the UK industry. We know that global dairy demand has outgrown global dairy supply and previous analysis conducted by Kite shows the global 'unsatisfied' dairy demand will structurally increase.

But global dairy production growth faces increasing constraints. Dairy farmers across the world are an aging population, many without a successor. Last generation older farmers do not continue to expand. In the traditional dairy exporting nations (NZ, NL, IRL) further farm growth will become increasingly constrained because of local environmental regulations around ammonia, nitrates and phosphates, as well as pressure on carbon emissions. In addition, investors do not perceive dairy as a clean or attractive industry for investment moving forward. This is partly due to perceptions about market opportunity, with the rise of plant-based alternatives, and partly relating to activist pressure on the industry around animal welfare and environmental performance. This has hurt dairy's image and access to capital tightens as a result, potentially limiting growth.

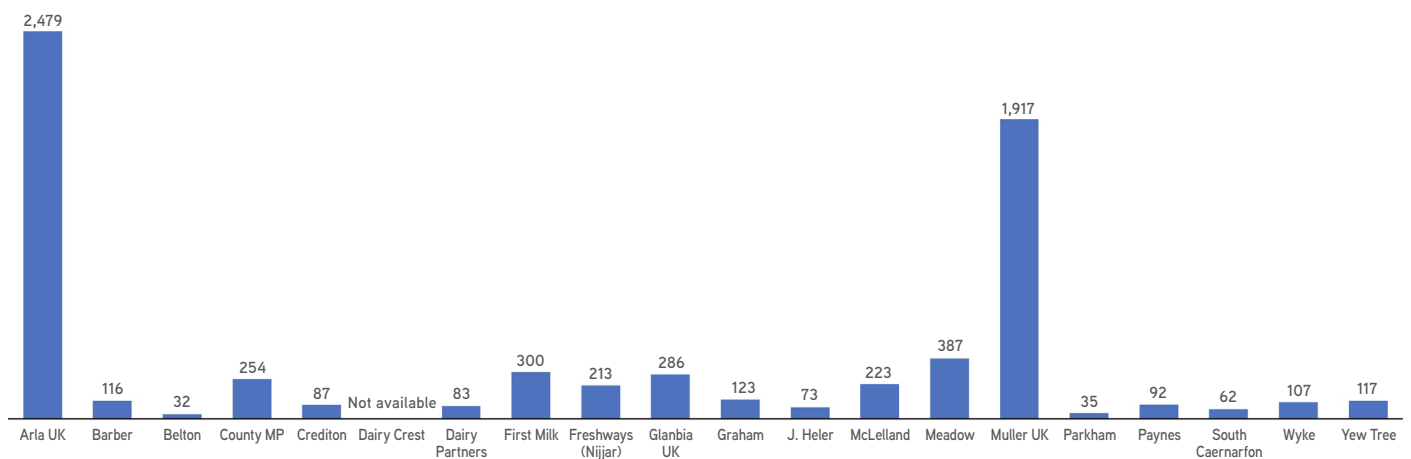
More recently, input cost inflation has also raised dairy production costs faster than these increases can be passed on to the consumer, limiting short term growth. In contrast to the above factors, however, this may not be structural, as the market tends to balance this type of adjustment in time.

What this analysis demonstrates is that farmers and processors serving the liquid market in the UK deliver lower milk pay-outs than competitors in different sectors within the UK marketplace, and considerably lower than the world milk price. Unsurprisingly, perhaps, processors in this sector also generate lower profits.

In Great Britain, in 2020 sales data was available for 19 out of 20 of the largest dairies, the exception being Dairy Crest (now Saputo), which is no longer obliged to specifically report UK sales, as they report globally aggregated financial results. This showed that GB dairy processors realised about £7bn in net sales in 2020, down around 3% versus 2019.

Net sales by GB-based processors (data for 2020; most recent data available on file)

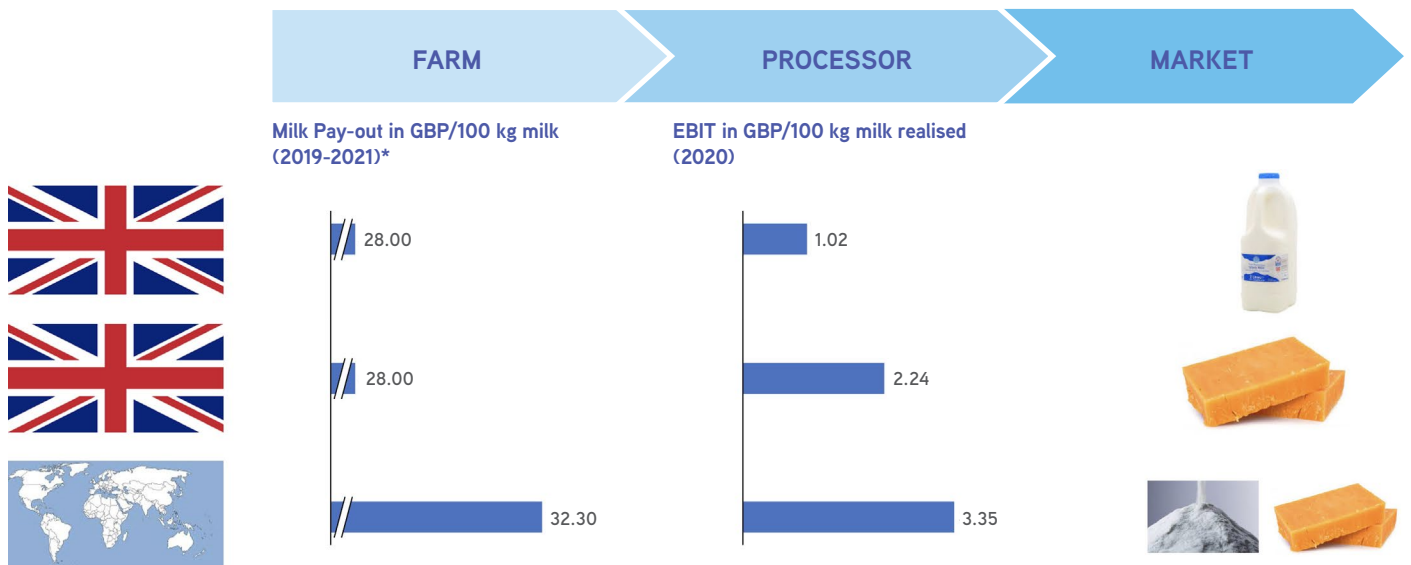
in million £



*Paynes data available for book year closing April 30, 2020; Wyke for book year closing March 31, 2020

Based on public domain data we calculated the weighted average EBIT for UK liquid-focused processors based on 2020 data as £1.02/100kg of milk. This figure is probably even lower for pure liquid returns, as many of the liquid processors also produce cheese or yoghurts, skewing the results upward. The weighted average for all other UK processors is £2.24/100kg. The conclusion from this is that, in the current market circumstances, GB liquid processing neither generates sufficient market returns to pay a competitive milk price nor to enable processors to make a meaningful profit.

When compared on a global scale, however, the picture is even more gloomy, with a group of leading global dairy processors generating an EBIT of £3.35/100kg of milk processed based on approx. 120bn litres of milk processed between them (around 10x total UK production). This shows the relatively poor returns of all UK processors due to their historic focus on the UK market and highlights the plight of those in the UK liquid sector. But it also highlights the potential for a new approach, accessing export markets and building on the strength of a successful UK dairy farming industry to flourish in the future.



*Liquid and Cheese/Ingredients prices paid in the UK have been depicted as equal, but as indicated in the text cheese/ingredients-market based milk prices have exceeded those paid to farmers linked to Liquid processors (source: IFCN)

Summary

This analysis demonstrates that:

- UK milk prices and milk returns have become low compared to world market prices, particularly in the liquid sector.
- UK dairy processors can improve their returns by accessing growing global markets – this wasn't an option in the past.
- This introduces a new dynamic in the dairy industry, particularly in the liquid sector, where the price differential is greatest.
- If UK retailers want to secure long-term liquid milk supply from supply chain partners that are committed to fulfilling their decarbonisation objectives, then they need to act to ensure that they are providing a fair market return.
- It seems unlikely that liquid milk as a retail loss-leader in the UK will remain viable.